County of Los Angeles
CHIEF ADMINISTRATIVE OFFICE
713 KENNETH HAHN HALL OF ADMINISTRATION • LOS ANGELES, CALIFORNIA 90012
(213) 974-1101
http://cao.lacounty.gov

DAVID E. JANSSEN
Chief Administrative Officer

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To: Supervisor Zev Yaroslavsky, Chairman
Supervisor Gloria Molina
Supervisor Yvonne B. Burke
Supervisor Don Knabe
Supervisor Michael D. Antonovich

From: David E. Janssen
Chief Administrative Officer

WASHINGTON, D.C. UPDATE

PRESIDENT'S PROPOSED FEDERAL FISCAL YEAR 2008 BUDGET

Budget Overview

On February 5, 2007, President Bush released his proposed $2.9 trillion budget for Federal Fiscal Year (FFY) 2008 with the goal of reaching a balanced budget within five years. The President's proposed budget mirrors the broad themes of his previous proposed budgets, and includes many prior proposals, including increased defense spending to fight the wars in Afghanistan and Iraq, entitlement spending reductions, especially for Medicare and Medicaid, and a sharp reduction in the growth of non-security discretionary programs. Congressional review of the President's FFY 2008 Budget begins this week as numerous House and Senate Committees have scheduled budget hearings.

The President proposes to increase overall funding for discretionary non-defense and non-homeland security spending by only one percent over estimated FFY 2007 funding levels, which is less than the 2.5 percent rate of inflation. Similar to last year, he also proposes to eliminate or significantly reduce funding for 141 discretionary programs, which would save an estimated $12 billion over the next five years. However, it is not possible to compare proposed FFY 2008 funding levels with enacted FFY 2007 funding levels at this time. This is because, to date, only the FFY 2007 appropriations bills for the Departments of Defense and Homeland Security have been enacted. All other

Federal programs and activities are temporarily funded under a Continuing Resolution, which expires on February 15, 2007. Therefore, the budget documents for the President's FFY 2008 Budget assume estimated FFY 2007 funding levels. Once Congress shortly completes action on the remaining FFY 2007 appropriations through a year-long FFY 2007 Continuing Resolution, it is expected that overall funding for non-security discretionary programs under the President's proposed FFY 2008 Budget would be approximately the same as in FFY 2007.

This memorandum presents our preliminary analysis of the President's FFY 2008 Budget based on the budget documents released today. We will provide your Board with a more detailed analysis after additional budget information becomes available and after FFY 2007 appropriations for all programs have been enacted.

Major Budget Reduction Proposals

The Administration proposes to eliminate or significantly reduce 141 discretionary programs, including many grants to state and local governments. Overall budget authority for state and local discretionary grants would fall from $138 billion in FFY 2006 to $126 billion in FFY 2008. The programs which are proposed for elimination include the following which also were proposed for elimination last year: State Criminal Alien Assistance Program (SCAAP); State and Local Law Enforcement Terrorism Prevention; Southwest Border Prosecutor Program; Community-Oriented Policing Services (COPS) Technologies; Justice Assistance Grant; Juvenile Accountability Block Grant; Preventive Health Block Grant, and Community Services Block Grant (CSBG).

Similar to last year, the President also is proposing to reduce Community Development Block Grant and Social Services Block Grant funding significantly, and to consolidate the Workforce Investment Act Adult, Youth, Dislocated Worker, and State Employment Service programs into a new Career Advancement Accounts Grant to states, which would be funded at a significantly lower level.

Unlike previous years, the President is proposing the following major reductions in homeland security grant funding to state and local governments:

- State Homeland Security Grant funding would be reduced by $275 million to $250 million in FFY 2008;
- Urban Area Security Initiative Grant funding would be reduced by $170 million to $600 million in FFY 2008; and
- Law Enforcement Terrorism Prevention funding would be cut by $175 million to $200 million in FFY 2008.

The Administration also proposes to reduce bioterrorism public health grant funding to $698 million and hospital preparedness grant funding to $414 million, funding levels which are significantly below the FFY 2006 levels.

Medicare and Medicaid

The largest budget reductions in the President's proposed FFY 2008 Budget would come from Medicare and Medicaid programs. The President proposes to reduce Medicare spending by more than $75 billion over five years, mainly by reducing provider reimbursement rates. Medicaid spending would be reduced by more than $25 billion over five years, mainly through proposals which would reduce Federal financial participation and, in effect, shift costs to state and local governments. Similar to last year, much of the Medicaid savings ($12.7 billion) would come from administrative proposals, including an estimated $5 billion in savings from the proposed Medicaid rule which would cap Medicaid payments to government providers to no more than the cost of providing services to Medicaid recipients. The County Department of Health Services has estimated that this proposed rule could result in an annual Medicaid revenue loss of $200 million to the County.

Other Budget Proposals

Child Welfare Programs: Similar to prior years, the Administration proposes to provide states with the option of receiving greater flexibility over the use of Title IV-E foster care funds in exchange for having their Federal funding capped over a five-year period.

State Children's Health Insurance Program (SCHIP): The Administration proposes to reauthorize SCHIP for five years at $5 billion per year, the same as in FFY 2007. The President also proposes to limit eligibility to children whose families have incomes at or below 200 percent of the Federal poverty limit. Currently, states have the option of extending SCHIP eligibility to children up to 300 percent of the Federal poverty level, and California's SCHIP program, Healthy Families, serves children up to 250 percent of the Federal poverty level.

Homeless Assistance Grants: The President proposes to increase Homeless Assistance Grant funding to $1.536 billion, which is $259 million more than the funding level in FFY 2006.

Temporary Assistance to Needy Families (TANF): The President proposes to reduce the current 90 percent work participation rate requirement for two-parent families to a 50 percent participation rate, which is the same as for all families. As previously reported to your Board, it is highly unlikely that most states, including California, would be able to meet the 90 percent work participation rate for two-parent families. States which fail to meet work participation rate requirements are subject to potential Federal fiscal sanctions.

Food Stamp Exclusion of Special Military Pay: The Administration proposes legislation to extend the provision in current law to exclude special military pay when determining Food Stamp eligibility for families of deployed members of the U.S. Armed Forces.

Budget Outlook

It is highly unlikely that the newly Democratic controlled Congress will approve the President's proposed spending reductions. Reflecting the change in priorities of the new Congressional leadership, the recently crafted FFY 2007 Continuing Resolution provides additional funding over the FFY 2006 levels for many programs. Even the Republican-controlled Congresses in recent years have rejected the President's deeper cuts in Medicare, Medicaid, and domestic discretionary programs, including his proposals to eliminate or significantly reduce funding for many state and local grant programs. We, therefore, believe that it is highly unlikely that the Congress will enact legislation to eliminate County priority programs, such as SCAAP and CSBG, or to make deep cuts in other priority programs, such as CDBG, as proposed by the President.

Due to Congressional procedural hurdles, the President's legislative proposals to reduce entitlement spending also face an uphill battle. The first major Congressional action in the FFY 2008 budget cycle will be the consideration of the FFY 2008 budget resolution, the budgetary framework which sets targets for total spending, total revenues, and allocations within the overall spending target for both discretionary and mandatory spending. While Democrats control both houses, prospects for reaching agreement on a budget resolution are far from certain. While the House is expected to pass a FFY 2008 budget resolution, Democrats, who hold a slim majority in the Senate, are far less likely to be able to pass a budget resolution. Without a budget resolution which includes reconciliation instructions for committees to report legislation to reduce mandatory (entitlement) spending, any legislation to enact reductions in entitlements, such as Medicare and Medicaid, would require a 60-vote margin to close Senate floor debate (i.e., to kill a filibuster or overcome other delaying tactics).

Further clouding the Congressional budget outlook, the House reinstituted a "pay as you go" (PAYGO) rule which requires that any legislation to increase mandatory spending or decrease revenues must include a corresponding amount of offsetting spending cuts and/or revenue increases in aggregate over six and eleven-year periods, including the current fiscal year. The Senate also employs a similar PAYGO rule on Senate revenue raising bills, although the rule may be waived on the Senate floor. PAYGO rules make it more difficult to pass legislation which otherwise would increase mandatory spending or cut taxes because of opposition from interests that oppose the offsetting spending cuts or tax increases.

It is noteworthy that the Administration included $5 billion in savings over five years from its proposed rule to cap Medicaid payments to government providers in its current services baseline estimate of Medicaid spending under current policies. If the Congressional Budget Office (CBO) were to include $5 billion in savings in its baseline estimates, then CBO most likely would "score" (estimate) that legislation to block implementation of the proposed Medicaid rule would increase spending by $5 billion over five years. To comply with the PAYGO rule, a like amount of spending cuts or tax increases then must be included in the legislation, making it more difficult to secure sufficient support to pass such legislation. PAYGO rules, in effect during the 1990s, notably made it impossible to enact legislation to block the imposition of a proposed Medicaid upper payment limit rule, which ended up reducing Medicaid payments to government providers.

The PAYGO rule does not apply to discretionary spending, which, instead, is subject to annual discretionary spending caps that are set annually. However, if the discretionary spending caps were to freeze spending at the prior year's level, then any increases, in effect, would have to be offset by a like amount of spending cuts.

We will continue to keep you advised.

DEJ:GK
MAL:MT:hg

c: All Department Heads
Legislative Strategist